PETITIONER'S BRIEF.

In this brief we shall discuss the "Reasons for Granting This Petition" in the order as given in the petition.

I.

As to the decisions of other circuits, see *Globe Indemnity Company* v. *Unity Railways Co.*, (Third Circuit) 272 Fed. 607, where the court says on page 609:

> "The surety on a contractor's bond has an equity in the reserved percentages, and has a right to expect and demand that no payments will be made contrary to the terms of the contract."

also *Ft. Worth Independent School District* v. *Aetna Casualty and S. Co.*, (Fifth Circuit) 48 F. 2d 1:

> Sections (2 and 3) on page 3 of the above decision disclose a remarkable similarity to the facts and contentions of defendant's counsel therein to the case at bar.

At page 4, Sections (4, 5) the court says:

> "A stipulation in a building contract that a percentage of the price would be retained until the final completion of the contract, is as much for the benefit of the surety as for the protection of the owner * * *."

and on page 5:

> "We can see no justification on the part of the school board in disregarding the provisions for retaining a percentage of the price * * *. It was called upon to respect the rights of the surety, and not to do anything which was reasonably calculated to increase its obligation or risk under the bond."

See, also:

National Surety Co. v. *County Board of Education*, 15 F. 2d 993 (Fourth Circuit).

Clayborne Parish School Board v. *Fidelity & Deposit Co.*, 40 F. 2d 577 (Fifth Circuit).

II.

The questions enumerated in the petition under "Basic Questions Involved," are most important, and should be settled by this court.

A.

The bond herein was a common form used throughout the United States. It stipulated that the things to be done by the obligee to prevent loss should be "conditions," the violation of which would excuse the surety from all liability under the bond. However, the Supreme Court of Ohio, in 1919, in *Royal Indemnity Co.* v. *Northern Ohio Granite Company*, 100 O. S. 373, held that where the construction contract provided that the contractor should pay all labor and material bills (as in the case at bar), the bonding company could not escape liability, regardless of any other bond conditions.

The Ohio Court of Appeals interpreted the bond at bar in *New Amsterdam Casualty Co.* v. *A. Wirtz*, 5 Ohio Opinions 80, in the same manner as the *Royal Indemnity Company Case, supra*, in spite of the admitted violation of the so-styled "conditions" in the bond.

Many states now have statutory laws and precedents controlling labor and material claims, similar to Ohio, and the determination of the effective force of such "conditions" is of very broad and general interest. If surety companies intending to sign surety bonds are to be liable as insurers, and if obligees may violate with impunity bond provisions which are called "conditions" but cannot so operate, such legal interpretations should come from no lower tribunal than the Supreme Court of the United States.

In *Woodruff* v. *Woodruff*, 44 N. J. Eq. 349, 1 L. R. A. 380, land was deeded "upon the following conditions," but later provisions in the deed prevented the grantor from treating these terms as conditions, just as in the case at bar provisions in the work contract, which was made a

part of the bond, and which also incorporated the bond within itself, made it impossible to treat these bond "conditions" as real conditions. The court says:

> "While the words 'provided nevertheless' and 'upon the following conditions' are appropriate to create a condition * * * they and similar words will give way when the intention of the grantor, as manifested by the whole deed, is otherwise."

In *Bruner Agency Company* v. *Smith*, 25 Ohio App. 21, at p. 29, the court says:

> "Courts will not ordinarily construe stipulations in a contract as conditions precedent unless it plainly appears that such was the intention of the parties."

See *Greene County, Kentucky,* v. *Quinlan*, 211 U. S. 583, on page 594:

> "It is not conclusive that the obligation thus imposed upon the railroad is called a condition. It frequently has been the case that the word 'condition' has been used in written instruments in a looser and broader sense than the law attaches to it. * * * When such an intent is discovered, the court has no difficulty in giving it effect."

The courts have consistently frowned upon contracting parties who violate contractual provisions designated as "conditions," and then set up such violation as a defense.

Weakley v. *Firebaugh*, 269 Ill. App. 123.
Hart v. *Pierce*, 125 So. 243, 98 Fla. 1087.
Jordan v. *Busch*, 1 N. E. 2d 745, 285 Ill. App. 217.
Walley v. *Mears Heel Company*, 4 Fed. Supp. 277.

If these provisions in the bond at bar are not real conditions, they are either promises or little more than a nullity. The obligee most obviously did not desire them to be a nullity, as it had them amended by inserting "two weeks" in place of "thirty days," to get quicker service from the surety in the event of the contractor's default. The obligee substantially observed these conditions until

the excavation was completed (when all danger of requiring the surety to complete the contract was over). Whereupon the obligee began to act in such reckless violation of the conditions of the bond as almost to show a desire to cause loss to the surety.

B.

The circuit court below not only disagreed with the trial judge, who interpreted these "conditions" as promises, but also refused to recognize that there was any contractual obligation at all between the district and the bonding company. The court says (p. 606): "The contract was between the district and the construction company, not between the district and the surety."

In arriving at this conclusion the court below, while recognizing that the contract was incorporated in the bond, completely ignored an outstanding controlling fact referred to by the trial judge (R. bottom p. 59), that the district had *expressly incorporated the bond in the work contract.*

With these two elements welding the work contract and the bond into one instrument, is it rational to contend that the contract is only "between the district and the construction company"? Is there any judicial theory by which an obligee can incorporate the bond in the principal contract to advance his own interest and then reject the bond from the contract to escape liability?

In this tripartite agreement between the district, the contractor, and the surety, there is every element of a contract. The statute required the district to procure a bond. With this knowledge the district prepared the contract for the contractor, and provided in the contract that whatever bond was obtained, its provisions should become a part of the work contract. Thereupon the contractor profered the bond in which it was also provided that the work contract should be a part of the bond. Whereupon this bond, profered as aforesaid, was accepted by the district, marked "approved," and the contractor au-

thorized to proceed with the contract. Here we have plainly an offer by the district to any bonding company, agreeable to the contractor, which was accepted by the petitioner, and the acceptance formally ratified by the district.

In this tripartite agreement between each two of the three contracting parties there was an offer, an acceptance, and a consideration—the basis of every contract.

C.

Should it be determined, however, that this two-way binding of the contract and the bond does not constitute a contract between the obligee and the surety, there still remains plaintiff's second cause of action based upon the normal *quasi* contractual obligation of an obligee to a surety, growing out of the legal requirement that the obligee must not violate its contract with the principal to the injury of the surety. The court below (bottom p. 606) says: "It is doubtful that a public body whose contractual powers are limited, may be made liable as to (do) private parties in relations *quasi ex contractu.*"

This startling doubt is very obviously based upon the decision of the Ohio Circuit Court in the *Village of Beechwood* v. *Ohio Casualty Company*, 47 Ohio App. 212, which holds that those public corporations which operate under limited statutory contractual powers cannot be held liable "in relations *quasi ex contractu.*"

Exhaustive research of all counsel in this case has found no other decision in the United States or England to support this principle. The court in the Beechwood case relied upon five Ohio decisions involving actions against public corporations on *implied* contracts, after an attempted express contract had been declared in violation of law. It is elemental law that an implied contract cannot be created as a substitute for an illegal express contract.

Dumphrey v. *Ryan*, 116 U. S. 491.

None of the authorities in the Beechwood case pertaining to *implied* contracts had the remotest bearing on *quasi contractual obligations.* The Supreme Court of Ohio has always recognized the full contractual powers and liabilities of all public corporations in the absence of restrictive statutes. See:

Cincinnati v. *Cameron,* 33 O. S. 336.
Cincinnati G. L. and C. Co. v. *Avondale,* 40 O. S. 257.
Commissioners v. *Ziegelhofer,* 38 O. S. 253 (see third paragraph on p. 529.)

Consequently, the Village of Beechwood case on the question of the *quasi* contractual liability of public corporations in Ohio is not a decision of the highest state court. This decision, furthermore, confines itself to public corporations of *limited* statutory powers. The conservancy district is not such a corporation. Please note the broad plenary powers set forth in Section 6828-6, Ohio General Code, *supra,* p. 3.

The attorney general of Ohio (O. A. G., 1933, p. 700) in interpreting these broad powers says:

> "The general rule of law * * * is that a grant of power to a public officer or board must be strictly construed.
>
> In the case of the conservancy act, however * * * the powers of the conservancy district * * * are not to be limited to those expressly granted, but are to include also the powers to perform all acts necessary and proper for the carrying out of the purposes for which the district was created.
>
> The directors are at liberty to do anything which is not out of harmony with any express limits on their action."

The Beechwood case was really rejected as an authority by the Sixth Federal Circuit Court itself, on October 15, 1940, in *Hochevar* v. *Maryland Casualty Com-*

pany, 114 F. 2d 943, where the court attempts to distinguish the Hochevar case from the Beechwood case with the statement that "the village was not obligated by the contract, as was the county here, to retain the percentages until materialmen and laborers are paid." Nevertheless, the court did hold in the Hochevar case that the county violated its contract with the principal contractor, and that the county *was* liable on a *quasi* contractual obligation. This is directly in conflict with the Beechwood case, and in peculiar disharmony with its "doubt," expressed herein below.

D.

The court below held that since the creditors of the contractor failed to attempt to procure a lien against funds in the hands of the district, the surety who paid these claims after suit is barred from his rights as subrogee, the theory being that the rights of the subrogee can rise no higher than the rights of the subrogor. This reasoning seems to result from a confusion between the subrogor's substantive right to be paid from funds in the hands of the district, and his remedy to protect that right. While it is, of course, true that a subrogee can have no rights of payment against a principal debtor, which the original creditor did not have, we submit there is nothing in the law which holds that the subrogee's *remedies* may not be different, either higher or lower, than those of the original creditor.

We have found no support for the Beechwood case precedent in the law of subrogation. The Supreme Court of Ohio has always recognized the subrogee's right to recover from the obligee who has acted to the injury of the principal's surety, regardless of the failure of the claimant to procure a lien against funds in the hands of the obligee. See *State* v. *Schlesinger*, 114 O. S. 323. In the *Hochevar Case, supra*, the Sixth Federal Circuit Court itself, in commenting upon the Beechwood case, says:

> "No importance should here be attached to the statement therein, that the rights of the surety can rise no higher than those of materialmen or laborers."

The facts in the Hochevar case differed somewhat from those in the Beechwood case, but one cold common fact in each case was that the claimants in both cases did *not* procure a lien against the debtor. If the subrogee's remedies were to be limited by those of the creditor in the Beechwood case, they certainly should have been in the Hochevar case if the Beechwood case were a precedent.

In addition to the subrogation law in the Beechwood case repudiating the accepted law of the Ohio Supreme Court, it was also *obiter dicta*. The Beechwood case primarily determined:

1. That there was no contract, express or implied, between the surety and the obligee, and

2. That the village could not be held liable under any *quasi* contractual obligation.

If the surety had no rights under either an express, implied, or *quasi* contract, he was completely shut out as a subrogee in any event, and any statement which the court made as to what his rights might be if he were a subrogee is obviously *obiter dicta*. That this *obiter dicta* of the Beechwood case, which was unfortunately followed by the circuit court of appeals below, is contrary to the overwhelming weight of authority, see:

> *Clayborne School Board* v. *Fidelity & Guaranty Co.*, 40 F. 2d 577.
>
> *U. S. Fidelity & Guaranty Co.* v. *City of Montesano*, 295 Pac. 935, 160 Wash. 565.

The court below expressed some doubt also as to the effectiveness of Sections 8324 and 8325 of the Ohio General Code, *supra*, to create a lien. It bases its doubt on *In re Schilling*, 251 Fed. 966. This reasoning is not ob-

vious. On the other hand, the Supreme Court of Ohio has always given full force and effect to these lien sections. See *State ex rel. Nixon* v. *Merrell,* 126 O. S. 239:

> "Under this statute (8324-5) a materialman or laborer, by following the procedure provided, may acquire a lien against funds appropriated by the state for the construction for which the material or labor was furnished."

Of course, it is obvious that after the district paid out the money due on the contract, the claimants could have no lien because there was nothing on which to attach a lien, but the "conditions" in the bond required the district to retain the money until the time for *lien notices* had passed. This was four months after the completion of the work. The district actually retained final payment for two days! (R. p. 51.)

III.

A comparison of the decision of the court below in the Hochevar case with the decision of the court below in the case at bar, is very persuasive that the court below in deciding the case at bar did not use its independent judgment herein, but did give undue and controlling effect to a decision of the Ohio Court of Appeals which decision was rendered after the rights of the parties herein had fully accrued.

There are five factual distinctions between the Hochevar case and the case at bar, three of which give the plaintiff herein a stronger right of recovery than that possessed by the surety in the Hochevar case, and the remaining two justify no distinction in legal principles.

1. The Hochevar case contained no provisions in the bond expressly binding the obligee to certain conduct as did the "conditions" of the bond herein.

2. The Hochevar case contained no provision in the bond and the contract expressly binding both into a single instrument.

3. The Hochevar case pertained to a county government whose contractual powers are more limited than those of the conservancy district.

4. In the Hochevar case the construction contract required that the percentage retentions be held until releases were procured, or an affidavit given that labor and material claims had been paid. In the case at bar the construction contract merely provided that releases should be supplied "if requested," but that retentions would be held until final payment, and that no payments would be made for overdepth excavation.

5. In the Hochevar case the obligee had notice of unpaid labor and material claims at the time of settlement. In the case at bar the plaintiff presented no evidence of such notice.

Distinctions 1 and 2 above give the plaintiff its first cause of action at law, which the surety in the Hochevar case did not claim to have. It is this legal cause of action which the court below seemed to completely overlook. If plaintiff herein is entitled to his legal cause of action, then distinctions 3, 4, and 5 above would have no pertinence whatsoever to plaintiff's legal rights.

Distinction 3 would give to the district a broader contracting power and a greater liability on *quasi* contractual obligations than were those possessed by the county in the Hochevar case.

Distinction 4 is merely one between the character of the clauses in the work contract which each of the respective obligees violated. There is no distinction in the legal principles involved in their violation. In both cases the result was that the obligee paid the principal without the surety's knowledge large sums of money before they were due. In the Hochevar case it was $17,278.34. In the case at bar it was $15,938.09.

If the violations of the contract by the district had been less flagrant, or of a nature only questionably damaging, the presence or absence of notice of outstanding claims might have had relevance; but in the case at bar, the violations were so pronounced and their natural consequences so obviously injurious to the surety, that the absence of knowledge of outstanding claims by the district at the time of payment could have no probative value.

The Hochevar case expressly repudiated the law of the Village of Beechwood case. Yet, the same court which decided the Hochevar case, in passing later upon plaintiff's equitable cause of action below, embraced *in toto* all of the law set forth in the Village of Beechwood case, from which it quotes largely verbatim.

The explanation is obvious. Following the decision of the Hochevar case the United States Supreme Court reversed the Sixth Circuit Court for failing to follow the Ohio Court of Appeals in *West* v. *American Telephone and Telegraph Company,* 61 Sup. Ct. Rep. 179. The decision herein below was most apparently an effort to comply with the Supreme Court's instruction.

The obvious purpose and effect of *Erie R. R.* v. *Tompkins,* 58 S. Ct. 817, was to give to state court decisions in questions of general common law the same controlling influence over federal decisions as had formerly been exercised by state court decisions in interpreting state statutes and local law. It has long been held by federal courts that state decisions interpreting state statutes were not controlling over federal court decisions when the state decision was rendered after the accrual of the rights of the litigants. See *Great Southern Fire Proof Hotel Co.* v. *Jones,* 193 U. S. 532:

> "The federal court is bound to accept decisions of the state courts construing state statutes rendered prior to the making of the contract on which the cause of action is based. Such duty does not exist in re-

gard to decisions of the state court rendered after the cause of action has arisen, although before the action itself was commenced, when the federal court in the exercise of its independent judgment reaches a different conclusion from the state court."

The same reasoning applies to state decisions of local law. See *Medical Arts Building Co.* v. *Minnesota Loan & Trust Co.*, 78 F. 2d 937:

> "Where no local rule of property has been declared at the time the rights of the parties accrue the federal court must exercise its independent judgment in the matter."

The legal rights of the parties herein accrued on March 25, 1933, the date on which The Miami Conservancy District wrongfully paid the Ward-Hayes Construction Company without making any retention to cover the period in which lien notices could be filed. There was some additional litigation necessary between the claimants and the surety to determine the amount of the claims and to protect the surety from being a volunteer so that his subrogation rights would not be affected. However, the basic rights and liabilities between the parties to this litigation were fully set and determined on March 25, 1933. The decision of the Village of Beechwood case was not rendered until March 12, 1934.

Can anyone who notes the widespread conflict between the decision of the sixth circuit below, and other federal circuits; who reads the Hochevar case where many of these same conflicting federal circuit decisions are cited with approval, and where the Village of Beechwood case is expressly repudiated; and who then reads the decision below, which not only embraces the legal concepts of the Village of Beechwood case, but extensively quotes therefrom—can any such person say that the court below exercised its independent judgment?

Conclusion.

This litigation is full of many questions of very great interest to local governmental units engaged in construction contracts, and to sureties generally. There is no express precedent interpreting the "conditions" used in many construction bond forms. Until the decision herein below the law was well settled that public corporations were liable as obligees on construction bonds to the same extent as private parties. Since the decision herein that law is now in great confusion.

Furthermore, a litigant who appeals to the federal courts ought to be informed as to whether his rights are to be wholly determined by later state court decisions to which he was not a party, and from which he has no appeal.

Respectfully submitted,

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